FILED
DEC 2 1 2006
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 06-234

IN THE

Supreme Court of the United States

INFORMATION SYSTEMS & NETWORKS CORPORATION,
Petitioner,

v.

UNITED STATES,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Federal Circuit

BRIEF OF *AMICUS CURIAE* CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA IN SUPPORT OF PETITIONER

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WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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INTEREST OF THE *AMICUS CURIAE* [1]

The Chamber of Commerce of the United States of America ("the Chamber") is the world's largest federation of business organizations. It represents an underlying membership of more than three million businesses of every size, operating in every sector of the economy and from every geographic region of the country. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. One of the Chamber's primary missions is to represent the interests of its members by filing *amicus curiae* briefs in cases involving issues of national concern to American business, including small business. This is such a case.

The Chamber is concerned about the federal government's attempts to penalize government contractors—mainly small businesses that have elected to organize in compliance with Subchapter S of the Internal Revenue Code ("S corporations")—by refusing to accept state income taxes paid by an S corporation as an "allowable" cost of federal government contract performance.[2]

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[1] Pursuant to Sup. Ct. R. 37.6, the Chamber of Commerce of the United States of America states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus curiae*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. The parties' letters of consent to the filing of this brief have been filed with the Clerk's office.

[2] An S corporation is a domestic business with no more than 75 shareholders, having one class of stock, in which all shareholders elect that the business be an S corporation. 26 U.S.C. §§ 1361(a), (b), § 1362(a). "C" corporation refers to an ordinary corporation and is defined in § 1361(a)(2) as "a corporation which is not an S corporation." Many of the current requirements and benefits in Subchapter S were adopted as part of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 Subtitle C §§ 1301-1317.

An allowable cost is an expense for which the contractor is eligible for reimbursement by the federal government. State income taxes paid by sole proprietorships and ordinary corporations are allowable costs of performing government contracts. In this case, the Federal Circuit employed a strained interpretation of the Federal Acquisition Regulation ("FAR"), which governs the procurement activities of an enormous spectrum of federal departments and agencies, to render such costs unallowable when they are incurred and paid by S corporations.

The position advocated by the United States directly contravenes its stated policy of assisting small businesses in selling products and services to the federal government. *See* Small Business Act, 15 U.S.C. § 631 ("Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns . . ."). Treating state taxes paid by S corporations as unallowable costs would result in an unfair penalty on small businesses that have elected to do business as S corporations, and it would discourage small businesses from contracting with federal agencies. The Chamber not only believes that, as a matter of policy, S corporations should be reimbursed for the same category of costs and expenses, including state income taxes, that are reimbursed to other business entities, but also that a plain reading of the FAR cost principles mandates this result. Supreme Court review is necessary because the Federal Circuit has reached a different, erroneous, and highly detrimental result.[3]

SUMMARY OF ARGUMENT

In reversing the United States Court of Federal Claims, the Federal Circuit's decision below, holding that an S corpo-

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[3] The Chamber also filed an *amicus* brief before the Federal Circuit in support of the contractor's position.

ration's state income tax costs are unallowable costs under the "Taxes" cost principle of the FAR,[4] is based on a misconstruction of the relationship between an S corporation and its shareholder. The court erred by failing to recognize that (i) the state tax liability in question is a tax derived solely from corporate income; (ii) the ultimate responsibility for payment of the tax rests with the corporation, and (iii) the taxes in question were actually paid by the corporation. *See* Petitioner's Appendix ("Pet. App.") 1a-10a. The trial court correctly recognized these factors and further held that the cost principle in question (48 C.F.R. § 31.205-41) makes no distinction between whether state income tax expenditures are incurred by ordinary corporations or S corporations. *See* Pet. App. 11a-30a.

There is no question that a government contractor doing business as either a sole proprietorship or a C corporation would be reimbursed for the cost of its state income taxes on income generated from performing federal government contracts. Thus, on either end of the spectrum of business organizations, such costs are allowable. By disallowing such reimbursement to S corporations, the United States is essentially penalizing small businesses that elect to organize themselves under subchapter S of the Internal Revenue Code ("IRC"). Such disparate treatment is inconsistent with the purpose underlying subchapter S and finds no support in the FAR itself. In addition, by disallowing reimbursement of state income taxes paid by S corporations, the Federal Circuit's holding conflicts with the underlying purpose of the Taxes cost principle, which is to create a level playing field among government contractors located in states with varying degrees of taxation.

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[4] Presumably, businesses organized as partnerships – which, like S corporations, pass through their tax liability to the individual partners – would suffer this same disparate treatment.

There are no other published decisions on this issue. Because of the Federal Circuit's exclusive jurisdiction over claims involving the government's contractual obligations under the FAR, that court's erroneous decision, unless reversed, will impact thousands of small government contractors across the nation. Such circumstances warrant review by the Supreme Court. *See generally*, R. Stern, E. Gressman, S. Shapiro & K. Geller, Supreme Court Practice 264, 265 (8th ed. 2002) (explaining that because of the Federal Circuit's exclusive jurisdiction over claims "involving many of the legal obligations of the United States . . . the issues in this type of litigation . . . can have a special importance that warrants review by the Supreme Court," and that "the decisions of the Federal Circuit . . . alone often settle the law in the absence of Supreme Court review").

ARGUMENT

I. REVIEW SHOULD BE GRANTED BECAUSE THE FEDERAL CIRCUIT'S DISPARATE TREATMENT OF "S" CORPORATIONS CONFLICTS WITH CONGRESSIONAL POLICIES AND INCENTIVES FOR ENCOURAGING SMALL BUSINESSES TO PARTICIPATE IN FEDERAL PROCUREMENT ACTIVITIES

A. Congress Has Required Government Agencies To Maximize Opportunities For Small Businesses To Perform Government Contracts

The Federal Circuit's view, supported by the United States, is that a cost which is reimbursable if it is incurred by an ordinary corporation is not reimbursable if it is incurred by a small business operating as an S corporation. Such disparate treatment significantly harms the ability of small businesses to compete with large corporations for the award of government contracts. In other words, if a small business must absorb a cost that a large business may charge as an expense

under its government contracts, its cost of doing business is going to be higher, and therefore, its ability to compete with the large business is going to be severely hampered.

Such a result is at odds with congressional policies, which recognize that fair competition and the encouragement and development of the capacity of small businesses are "basic not only to the economic well-being but to the security of this Nation." 15 U.S.C. § 631(a). In this regard Congress stated in the Small Business Act:

> It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as possible, the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government . . . be placed with small-business enterprises . . . .

Id. In order to achieve that goal, Congress further mandated:

> [I]t is the continuing policy and responsibility of the Federal Government to use all practical means and to take such actions as are necessary, consistent with its needs and obligations and other essential considerations of national policy, to implement and coordinate all Federal department, agency, and instrumentality policies, programs, and activities in order to: foster the economic interests of small businesses; insure a competitive economic climate conducive to the development, growth and expansion of small businesses . . . .

The question in this case has significant financial impact on the thousands of small businesses that provide products and services to government agencies. The United States' view that state income taxes paid by S corporations are unallowable puts those contractors at a disadvantage when competing against larger corporations whose expenditures for

state income taxes are reimbursed and, therefore, contradicts Congress' policy directives.

B. The "Pass-Thru" Provisions Of The Internal Revenue Code Do Not Result In An "Exemption" To A Subchapter S Corporation's State Income Tax Liability

The FAR expressly provides, under the "Taxes" cost principle, that state income taxes are allowable costs. "The following types of costs are allowable . . . Federal, State, and local taxes . . . except as otherwise provided in paragraph (b) of this section that are required to be and are paid or accrued in accordance with generally accepted accounting principles." 48 C.F.R. § 31.205-41(a). Under paragraph (b) of the Taxes cost principle, tax costs are unallowable if the contractor is exempt from paying the taxes. "The following types of costs are not allowable: . . . Taxes from which exemptions are available to the contractor directly, or available to the contractor based on an exemption afforded the Government . . . . The term 'exemption' means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise." *Id* § 31.205-41(b)(3). The United States argued below that state taxes paid by an S corporation are not an allowable cost because S corporations are "exempt" from paying state income tax, as that term is used in the FAR.

In accepting the United States' position, the Federal Circuit reversed the trial court and misconstrued the term "exempt" in the FAR by failing to consider the context in which the IRC treats the income of an S corporation. As the trial court correctly observed, the manner in which the income of an S corporation is taxed does not render the corporation "free" or "exempt" from such taxes, but rather the S corporation's tax

liability is *transferred* to the corporation's shareholder. Pet. App. 21a. The trial court held:

> Plaintiff, as an S corporation, is not relieved of state tax liability, but is simply required to pass its liability on its corporate income to [the shareholder].

Ibid. The IRC itself refers to this transfer of liability as a "pass-thru." 26 U.S.C. § 1366. Some commentators refer to the pass-thru provision as a "taxation alternative" or "conduit concept," under which the S corporation form of organization is the conduit for taxable income to flow from the corporate level to the shareholders for purposes of reporting the corporate income on the shareholder's personal income tax return. *See, e.g.,* Warren Paul Kean, "After the Facelift, Is Subchapter S Any More Attractive?" 46 La. L. Rev. 87, 91, 93 (Sept. 1985). Under the IRC, corporate income and expense items are passed through and taxed to the shareholders at the corporation's year end. 26 U.S.C. §§ 1367(a), 1368. Accordingly, the shareholder, as a conduit for payment of *the corporation's* state income tax, is taxed on the corporate income whether or not it is actually distributed to the shareholder. *See* Kean, *supra* at 103; *see also* 26 U.S.C. § 1366(a) (shareholder's tax liability is determined by taking into account the shareholder's pro rata share of the corporation's items of income).

The Federal Circuit decision glossed over the "pass-thru" nature of what is in all respects (i) the *corporation's* tax liability, and (ii) a cost incurred in performing government contracts. The decision ignored the fact that the state taxes at issue were actually paid by the S corporation when it reimbursed its sole shareholder for the state taxes she paid on corporate earnings. *See* Pet. App. 14(a) (trial court noted that Petitioner Information Systems & Networks Corp. ("ISN") reimbursed its shareholder for the tax payment in question, as contemplated and allowed by the IRC). The Federal Circuit

apparently overlooked this finding when it erroneously stated that ISN did not incur the costs in question:

> As an S corporation, ISN never paid any state income taxes. Only Ms. Malkani paid state income taxes on dividends paid to her from ISN.

Pet. App. 7a-8a. The United States made the same mischaracterization in concluding that "the state income taxes paid by Ms. Malkani were not allowable costs for ISN." Pet. App. 5a. It is disingenuous to categorize the costs in question as costs paid by the shareholder. ISN did precisely what the IRC contemplated when it passed the tax through to its shareholder and then reimbursed her for the tax. Because the subject costs were actually paid by ISN, the question is whether this particular tax expenditure on ISN's books should be treated any differently from state tax expenditures on the books of a C corporation.[5]

The disparate treatment advocated by the United States would result in a windfall to the contracting government agency because it would avoid reimbursing S corporation contractors for costs that are reimbursed to other government contractors. In that regard, when the IRC "S" provisions are read in conjunction with the FAR Taxes cost principle, the only reasonable conclusion is that state tax costs incurred by the S corporation are allowable. The United States' position reflects a social judgment, not a conclusion grounded in the law. In essence, the United States believes the owner of the S corporation somehow would be advantaged by the reimbursement of her state taxes. There is no social or economic basis for that judgment because state taxes are a

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[5] The question of cost allowability does not turn on whether the tax costs were paid directly to the state by the S corporation or whether the S corporation reimbursed the shareholder for her payment to the state. Regardless of which procedure is used, the tax costs would appear the same on the corporation's books and would be subject to the same degree of government agency auditing as any other incurred cost.

cost of doing business no matter how the business is organized. As such, the costs are indistinguishable from other costs reimbursed by government agencies.

The Federal Circuit stated, in conclusory fashion, that the shareholder "is not the contracting entity." Pet. App. 8a. That is an over-simplification which fails to understand that the very purpose of IRC subchapter S is to recognize the identity of interest of the individuals and the corporation, much as though it were a proprietorship. The trial court correctly observed that while the corporate shareholder and the S corporation are indeed legally distinct entities, their "relationship . . . is an important and intermingled one for state tax purposes." Pet. App. 23a. In this "closely intertwined" relationship, it is the corporate entity which, under many state tax codes, is ultimately responsible for ensuring payment of the taxes on the corporate income. *See* Pet. App. 24a (noting that (i) some states require the S corporation to pay the taxes on behalf of its shareholders or withhold such amounts from shareholder distributions, and (ii) in the event the taxes are not paid, the corporation will be subject to penalty and encumbrance on its ability to do business in the state. Pet. App. 24a-25a.

The Federal Circuit completely ignored the point that the ultimate liability for the tax rests with the S corporation. Instead, it focused entirely on the irrelevant point that any "penalties and encumbrances" that might be incurred by a corporation would themselves be unallowable costs under the FAR. Pet. App. 8a. The issue here is not the allowability of penalties. The relevance of the petitioner's argument regarding the S corporation's potential liability for payment of penalties to the state when the shareholder does not pay state income tax is to demonstrate that the corporation is ultimately responsible for paying the tax itself. Whether a particular state tax code uses the term "corporate tax liabilities," "withholdings" or "shareholder income tax," the fact remains

that state income taxes on S corporation income are statutorily-mandated costs of doing business for S corporations. That fact not only confirms the trial court's conclusion that the tax obligations of the corporations and their shareholders are "intermingled," but also confirms that the costs paid by the S corporation are reasonable and allowable pursuant to the FAR cost principles.

C. Treating The Subject Tax Costs As Allowable Under The FAR Would Be Consistent With The "Tax Neutral" Intent Of Subchapter S

The trial court correctly pinpointed the purpose underlying a small business's decision to incorporate under Subchapter S of the IRC – to carry on its activities in a corporate form but without incurring the "double taxation" that normally is applied to corporate income.

> S corporation status is a tax election designed to make the decision of a small business to incorporate "tax neutral;" i.e., a business will incur the same tax liability on its income whether the owners of the business incorporate or not.

Pet. App. 13a.

This view was reflected more than 50 years ago by President Eisenhower in his budget message to the 83rd Congress:

> Small businesses should be able to operate under whatever form of organization is desirable for their particular circumstances, without incurring unnecessary tax penalties. To secure this result, I recommend that corporations with a small number of active stockholders be given the option to be taxed as partnerships . . . .

Tax Recommendation § 16, Budget Message of January 1953.[6]

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[6] *See also, Klein v. Comm.*, 75 TC 298, 302-03 (1980) (quoting S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958)) ("Congress sought to allow a

When Congress enacted the Subchapter S Revision Act of 1982, its intention was to minimize further the effect of income taxes on choices of the form of business organization by continuing to enable small business to have the benefits of incorporation without the incidence of income taxation at both the corporate and shareholder levels. S. Rep. No. 640, 97th Cong., 2d Sess. 5, *reprinted in* 1982 U.S.C.C.A.N. 3253-57.

Subchapter S exists as a hybrid taxation mechanism in which S corporations are intended to have many of the advantages of both the corporate and partnership forms of operation.[7] The chief advantage is designed to be tax *neutrality* – the avoidance of double income tax on corporate earnings; *i.e.*, a tax applied when the corporation earns the income, and a second tax applied when that income is distributed to the individual shareholder. Thus, if a small business is organized as a partnership (with the partners individually incurring the tax liability on behalf of the business), but the partners wish to take advantage of a corporate structure, they may do so without incurring the tax at both the corporate and individual levels.

Under the Federal Circuit's holding, while the S corporation performing government contracts does not face the prospect of double taxation, it nevertheless faces a severe adverse consequence with respect to its inability to recover the costs of its state tax liability – costs which clearly would be recoverable if the business were organized differently. As noted above, the Federal Circuit held, in part, that the costs in

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small business corporation to be taxed much like a partnership so that 'businesses [can] select the form of business organization desired, without the necessity of taking into account major differences in tax consequence'").

[7] Among the advantages of operating in the corporate form are limited liability, centralization of management, continuity of life, and free transferability of ownership interests. *See* Kean, *supra* at 91.

question were not allowable because the shareholder herself was not the contracting entity. Pet. App. 8a. In that regard, if the contracting entity were simply an individual carrying on a sole proprietorship, there would be no question that the individual's state income tax on earnings from government contracts would be an allowable cost. Likewise, if that individual elected to organize her business as a C corporation, and the C corporation became the contracting entity, there is no question that the C corporation's state income taxes on income from its government contracts would be an allowable cost for reimbursement. Thus, on either end of the spectrum of business organizations, such costs are allowable. But under the United States' view, as accepted by the Federal Circuit, small businesses falling in the middle of the spectrum – those organized as S corporations – are inherently ineligible for this same cost reimbursement benefit.

The trial court correctly held that there is no basis in Subchapter S's pass-thru provisions for denying reimbursement under the FAR for the corporation's state tax expenditures. The trial court could not identify any reason that a business should lose out on such reimbursement solely because of its organization as an S corporation. Pet. App. 21a-22a.

Nor can the United States assert any policy justification under the IRC or the FAR for denying reimbursement. Indeed, to hold that such costs incurred by an S corporation are unallowable would be akin to imposing a penalty on the S corporation purely because of the form of the organization. By rendering the subject costs unallowable for reimbursement under the contract, the United States is, in effect, giving rise to an unintended adverse tax consequence based purely on the form of the business organization. Accordingly, the United States' view that S corporations should be singled out under the FAR cost principle – which otherwise provides reim-

bursement for state tax liability – runs afoul of the purpose behind Subchapter S of the IRC.

II. REVIEW SHOULD BE GRANTED BECAUSE THE FEDERAL CIRCUIT'S OPINION CONFLICTS WITH THE PLAIN LANGUAGE OF THE FAR "TAXES" COST PRINCIPLE THAT RENDERS THE SUBJECT COSTS ALLOWABLE

The trial court correctly held that "[n]othing in the FAR provisions involved in this case points to an intent that certain types of commercial organizations should be denied reimbursement altogether simply because of their tax election or corporate structure." Pet. App. 20a-21a. The Taxes cost principle in the FAR provides that state taxes are allowable if they are "required to be and are paid or accrued in accordance with generally accepted accounting principles." 48 C.F.R. § 31.205-41(a)(1). Thus, "State income taxes in general are allowable costs under the section" (Pet. App. 19a); however the United States' position is that this allowability is available only to contractors organized under other forms, sole proprietorships as well as publicly traded Fortune 500 C corporations.

One of the goals of the FAR is to create a level playing field among businesses seeking to sell goods and services to the federal government. *See, e.g.*, 48 C.F.R. § 1.102-2(c)(3) (one underlying purpose of the FAR is to codify rules which treat all contractors and prospective contractors fairly and impartially); 48 C.F.R. § 19.201(a) ("It is the policy of the Government to provide maximum practicable opportunities in its acquisitions to small business, veteran-owned small business, service-disabled veteran-owned small business, HUBZone small business, small disadvantaged business, and women-owned small business concerns"). The Federal Circuit's interpretation of the Taxes cost principle, disal-

lowing reimbursement of state tax costs to S corporations, skews the field to the extreme ends of the business spectrum.

In addition, the Taxes cost principle is intended to create a level playing field by removing geographic disparities from the competition for government contracts. J. Bedingfield & L. Rosen, Government Contract Accounting (2d ed. 1985), p. 10-31. In that regard, the reimbursement of state income taxes ensures that a contractor doing business in a state with high income taxes will not have to incur greater costs than a contractor located in a state with little or no income taxes. The Federal Circuit's holding is inconsistent with this underlying purpose of the Taxes cost principle.

Because the state tax costs at issue here are, in fact, routinely paid by S corporations (either by reimbursing shareholders or by paying the taxes directly to the state), and because the FAR makes no distinction between the type of business organization that incurs the expense of state taxes, the plain language of the cost principle renders the S corporation's taxes as allowable costs. The United States cannot point to any provision in the FAR which provides for or even hints at disparate treatment for small businesses or S corporations. In interpreting statutes or regulations, courts must look to "the language itself, the specific context in which that language is used, and the broader context of the statute as a whole." *Robinson v. Shell Oil Co.*, 519 U.S. 337 (1997).

The United States argued below that the reason such costs should be unallowable is that the "pass-thru" provision of Subchapter S is the same as an "exemption" from having to pay state taxes, as the term "exemption" is defined in 48 C.F.R. § 31.205-41(b)(3). But there is no authority equating the IRC's "pass-thru" provisions with the FAR's use of the term "exemption." The trial court correctly recognized that the "pass-thru" provision "is not a tax exemption in the normal sense of the term" because the pass-thru does not

result in an "abatement" or the complete absence of the tax liability. Pet. App. 21a.

Indeed, the FAR itself describes the purpose behind making tax expenses unallowable in some circumstances:

> These provisions intend that tax preference attributable to Government contract activity be realized by the Government.

48 C.F.R. § 31.205-41(b)(3). This is a reference to FAR Part 29, which prescribes policies and procedures for government agencies, and in some instances for contractors, to assert immunity or exemption from state and local taxes. *See* 48 C.F.R. § 29.000, § 29.303; *see also* 48 C.F.R. § 31.205-41(a)(1) which references FAR Part 29. In that regard, the "exemption" referred to in the cost principle

> means freedom from taxation in whole or in part and includes a tax abatement or reduction resulting from mode of assessment, method of calculation, or otherwise.

48 C.F.R. § 31.205-41(b)(3).

The trial court correctly found that the S corporation's "transfer of liability" to the shareholder did not result in a tax abatement. Pet. App. 22a.[8] The United States, without support, argued before the Federal Circuit that § 31.205-41(b)(3) (the provision making tax expenses unallowable when the contractor is exempt from taxation) does not re-

[8] The trial court correctly described the distinction between the IRC's provisions for "transferring" tax liability to the S corporation's shareholder and an "abatement" of the tax liability. Pet. App. 21a. In fact, the tax liability arises and is incurred at the corporate level. Pursuant to the IRC provision – which is intended to enable small businesses to avoid adverse tax consequences from organizing as a corporation – the tax liability on the corporate income is passed through to the shareholder, but the taxes are routinely paid or reimbursed in the normal course of business by the corporation.

quire an "abatement" of tax liability because the term "abatement" is only one example of an applicable exemption. Pet. App. 7a.

That assertion ignores the plain meaning of the language preceding the word "abatement" – "freedom from taxation." Those words have a plain meaning and stand for an unremarkable straightforward proposition – if the business incurs no taxation on its income, then costs incurred in paying taxes, which ultimately end up not being owed, are not subject to reimbursement under the FAR. *See* Pet. App. 29a (in which the court noted that the provision is designed to preclude a contractor's double recovery of taxes in the event it receives both a refund from the state and reimbursement under its federal contracts).

The United States' effort to turn this provision into a disallowance of tax expenditures incurred by S corporations finds no support in the text of the cost principle.

III. REVIEW SHOULD BE GRANTED BECAUSE THE SUBJECT COSTS ARE REASONABLE UNDER THE FAR AND ARE THEREFORE ALLOWABLE

Assuming *arguendo* that the Taxes cost principle at 48 C.F.R. § 31.205-41 does not expressly apply to the costs incurred by an S corporation either in reimbursing its shareholders for their payment of state income tax on income generated by the S corporation, or in paying those taxes directly to the state, the costs are still "reasonable" pursuant to the FAR cost principles, and therefore allowable.

The allowability of costs incurred by a government contractor depends principally on the reasonableness of those costs, and whether they are subject to any specific limitations set forth in the FAR cost principles.[9] 48 C.F.R. § 31.201-

[9] "Allocability," the third principal factor in determining allowability, *see* 48 C.F.R. § 31.201-2(a)(2), is not an issue here.

2(a). Pursuant to the FAR, a cost is reasonable, and therefore, in the context of this appeal, allowable, "if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." 48 C.F.R. § 31.201-3(a). The reasonableness of an incurred cost depends on a variety of factors, including: (i) whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance most notably, and (ii) generally accepted sound business practices, arm's-length bargaining and Federal and State laws and regulations. 48 C.F.R. § 31.201-3(b).

An S corporation's payment of its shareholder's state income tax attributable to income generated by the S corporation is such a reasonable cost. The election to do business as an S corporation is a reasonable business decision. By paying the taxes generated by its income, the S corporation performing government cost reimbursable contracts incurs an expense that does not exceed that which would be incurred by a prudent person in the conduct of competitive business. In this case, an S corporation reasonably paid that part of the state income tax imposed on its shareholder on that portion of her income that was generated by the corporation itself. The fact that the amount of the expense is determined in accordance with state law further suggests the reasonableness of the amounts at issue.

Moreover, it is reasonable for an S corporation to pay the portions of its shareholders' state income taxes that are attributable to income generated by the corporation because – unlike the shareholders of C corporations – an S corporation's shareholders are taxed on the corporation's earnings rather than on the cash that is distributed to them. By the same token, it is also an advantage for a small business to be able to retain earnings to increase its flexibility in paying other expenses, which flexibility would be curtailed if shareholders were to demand cash distributions sufficient to meet their

corporate income related tax liabilities. Accordingly, it is common, and certainly reasonable, for S corporations to enter into agreements to reimburse the shareholder, or pay the tax on the distribution of shareholder's income attributable to the corporation.

With regard to costs that are not specifically addressed by 48 C.F.R. § 31.205, that section

> does not cover every element of cost. Failure to include any item of cost does not imply that it is either allowable or unallowable. The determination of allowability shall be based on the principles and standards in this subpart and the treatment of *similar or related items*.

48 C.F.R. § 31.204(c) (emphasis added). Accordingly, an item of cost that is not specifically addressed by the principles in FAR 31.205 may nonetheless be allowable if it is reasonable (and allocable to the contracts at issue). *Cf. Gould Defense Systems, Inc.*, ASBCA No. 24881, 83-2 BCA ¶ 16,676 (amortization of goodwill recognized as allowable cost, although not specifically addressed by cost standards; recognition that amortization of goodwill and other intangible assets, such as patents, copyrights, leases, licenses and franchises, may be accounted for as incurred costs under GAAP as well).[10]

Assuming that the Court accepts the United States' strained argument that the cost at issue here is not specifically addressed in the FAR's Taxes cost principle, it is certainly

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[10] The United States could challenge the clear and plain language of the Taxes cost principle by proceeding through the regulatory change process, which would include a notice and comment period which would permit a full review of the new anti-small business policy it asks the courts to sustain. For example, the United States' reaction to the *Gould* decision was to promulgate a new cost principle at 48 C.F.R.§ 31.205-49, which makes the amortization, expensing, write-off or write-down of goodwill expressly unallowable. *See BAE Systems Information,* ASBCA No. 44382, 01-2 BCA ¶ 31,495.

"similar or related" to a "selected item," state tax, that is addressed and is allowable. *See* 48 C.F.R. § 31.205-41(a)(1). *Cf. Southwest Marine, Inc.*, ASBCA No. 54234, 2005 WL 467158 (Feb. 23, 2005) (determination of allowability of costs not specifically addressed by FAR cost principles includes analysis of treatment of selected items that are similar or related).

A state tax expense that is reimbursed or directly paid by the S corporation instead of by the shareholder is a type of cost that would generally be recognized as ordinary and necessary for the conduct of an S corporation's business; if it were not, there would be considerably less incentive for a government contractor to do business as an S corporation. Indeed, "[t]he implied promise of Subchapter S is that distributions equal to net corporate income will not result in a 'double' tax." J. Eustice & J. Kuntz, Federal Income Taxation of S Corporations (3d ed. 1993), ¶8.01[1].

It is also eminently reasonable for S corporations to pay the state income taxes of their shareholders on income attributable to the corporations in light of the tax payment or withholding requirements in several states with respect to shareholders who reside outside the taxing state, as noted above. Accordingly, the principles and standards in the FAR render the subject costs reasonable and allowable.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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December 2006